

Executive Summary

Turn the tap and the water flows. On Thursdays the garbage gets collected. When it gets dark, the streetlights go on.

In many communities these are government services that are taken for granted. But democratic government is not designed to function in obscurity or anonymity. Absent citizen involvement, government agencies of all sizes are prone to inefficiencies and public resources are vulnerable to abuse.

The Little Hoover Commission found that independent special districts often lack the kind of oversight and citizen involvement necessary to promote their efficient operation and evolution. And without robust mechanisms of public accountability, inefficiency can become routine and the occasional scandal inevitable. Some examples:

- ❑ Independent special districts, according to the most recent information available, have \$19.4 billion in reserves – nearly 2½ times their annual gross revenues. Yet in many cases, community and state leaders do not know the size of these reserves and why they are being held – and as a result, these resources are often not integrated into regional and statewide plans for fortifying the State’s infrastructure.¹

- ❑ Twenty-four health care districts in California no longer operate hospitals. Most continue to receive property taxes, which might be better spent on other community needs. Some provide services that could be administered by other agencies. Most of the districts report that they have not considered dissolution.

- ❑ Consolidations, even when they make sense, are hard to accomplish. It took five years of intense pressure from the Orange County Local Agency Formation Commission to merge three small water purveyors into one. The reorganization, within three to five years, is expected to save more than \$1 million a year. Similar opportunities for savings can be found throughout the state, but are lost because the mechanisms for reform are thwarted by the power of the status quo.

California has 58 counties, 474 cities – and more than 3,800 special districts. About two-fifths of those districts are considered “dependent” because they are governed by a larger entity, such as a county board of supervisors. But more than 2,200 of these districts are “independent,”

governed by their own elected bodies, including park districts, water districts, hospital districts and sanitation districts.

Many independent districts also are “enterprise” districts, like water and sewer agencies, which directly charge customers fees for the services they provide. Others, such as library and park districts, are “non-enterprise” districts, which rely mostly on property tax revenues to serve their communities.

The Commission focused on independent districts – both fee-based enterprise districts and tax-dependent non-enterprise districts.

Many of these independent special districts were created to extend public services – such as drinking water or parks – to rural and slowly developing communities that were beyond the reach of incorporated cities. But many, such as the water districts in Orange County, survive as separate government agencies even after urbanization has paved over the economic or geographic reasons for their independence.

Some districts have evolved in ways that cities and counties cannot – to manage consolidated fire protection services and regional parklands. Others, such as the health care districts, were created to provide a unique service, but persist after that service is provided by another public or private organization. Very few districts close their doors on their own initiative.

If no news is good news, the vast majority of districts are successful, and clearly many are. But most Californians would be hard pressed to identify the providers of some of their most basic services or to assess whether the fees are appropriate and the quality is what it should be.

The essential lesson of the last decade is that successful enterprises – public or private – are those that understand the needs of their customers and continuously strive to improve the services they offer. Similarly, successful organizations evolve to capture efficiencies and to align their core competencies with customer needs. Bigger is not always better, and sometimes smaller is.

But most special districts were formed when California looked different than it does today. Nothing ensures that these districts evolve to whatever size, shape and governance structure makes the most sense – given contemporary technologies, economics and social considerations. Local Agency Formation Commissions (LAFCOs) were created to be the venue for these discussions and catalysts for change. If strengthened, LAFCOs hold the best promise for individual communities to shape their government.

The Commission believes its reforms would yield improvements in three areas:

- ❑ ***Improved public involvement and scrutiny.*** The complexity and pace of modern life has diminished the electoral process as a mechanism for ensuring that government – and special districts in particular – provide greater value with fewer resources. Special districts need to be more visible to the public they serve and to community and business leaders who can influence decisions.
- ❑ ***The efficient evolution of independent special districts.*** Fiscal and political pressures have brought about some consolidations and reorganizations of small special districts that collectively serve large urban areas. But Local Agency Formation Commissions can be fortified to more effectively facilitate prudent changes.
- ❑ ***More vigorous review of public resources.*** Some 195 independent enterprise districts have reserves greater than five times their 1996-97 gross revenue. But these resources are often not incorporated into community and statewide discussions about how to improve infrastructure or reduce the cost of living and doing business in California. Similarly, nearly 600 enterprise districts continue to receive more than \$400 million in property tax revenue, while many other districts providing the same services rely solely on fees. State and community leaders need to openly reconsider how these resources are being used.

To accomplish these reforms, special districts need to be more visible and Local Agency Formation Commissions need to become advocates for improvement. To challenge the status quo, policy-makers need a better understanding of the potential benefits of reorganizing special districts. State and community leaders need to know more about the assets held by special districts, and they must reassess the lingering reliance of some enterprise districts on property taxes.

Many of the Commission's recommendations for special districts should become standards for all governments – making themselves more understood and relevant to their constituents. The recommendations in this report concern independent special districts because that was the focus of the Commission's study – not because other local governments and state agencies are immune to inefficiency.

These recommendations are offered to state policy-makers for formal consideration and some would require state direction and support. But many of these practices could be voluntarily adopted by independent

special districts and Local Agency Formation Commissions working with civic and business leaders in their communities.

A fundamental question facing California is how it will be governed in the 21st Century. The government closest to the people is often times a special district. Sorting out the problems and the potential of these districts will help state and community leaders in what should be a continuous pursuit of improved services at lower costs. In that spirit the Commission finds and recommends the following:

Finding 1: Special districts are often invisible to the public and policy-makers, compromising oversight and accountability.

In contrast to general-purpose local governments, special districts often operate in relative obscurity, hidden from the scrutiny of the public they were created to serve. The accountability mechanisms that do exist – financial information filed with the State Controller and the electoral process – are often inadequate. Districts submit financial information to the State Controller that is not easily accessed or understood by the public or policy-makers.

Research conducted by the Commission found that in Sacramento and Contra Costa counties the electoral process for special districts is less vigorous than for city council elections. It found that fewer races were competitive, more seats were filled with appointments and fewer voters participated in special district elections than other local elections. Sacramento County did increase participation in special district elections when it consolidated those elections in even years – but not even that effort brought special district elections in line with city councils.

Equally important, the media, interest groups and active citizens who frequently observe the actions of city and county governments understandably do not participate at the same level in special district governance. The city manager of a small Southern California coastal city, speaking in support of a city takeover of a water district, compared an average turnout of 75 people at city council meetings to no citizen attendance at water district meetings.¹

For this and other reasons, when problems or abuses do occur, they often do not come to the attention of the public or policy-makers until they are egregious and the remedies drastic. In the controversy involving the Water Replenishment District of Southern California, officials from the cities served by the district were shocked to learn the size of the district's reserve funds that took several years to amass. Relationships

with other local governments, as well as broad citizen participation, would enhance the visibility and accountability of special districts.

Recommendation 1: The Governor and Legislature should enact legislation that would make special districts more visible and accountable. Specifically, the legislation should:

- ***Require special districts to actively make their activities visible to the public.*** To help the public – as citizens, consumers and voters – to participate effectively, independent special districts should annually develop and publicize the following information, stated in easily understood terms:
 - ✓ District mission and purpose
 - ✓ Summary financial information presented in a standard format and simple language, including reserve funds and their purpose
 - ✓ District policy on the accumulation and use of reserves
 - ✓ Plans for the future, including anticipated revenues, expenditures, reserves and trends in user rates
 - ✓ Per capita tax contributions of property owners
 - ✓ Performance and quality of service indicators
 - ✓ Board member benefits and compensation

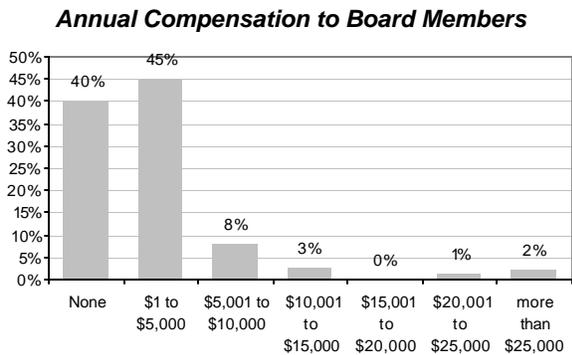
Financial information should be posted on Web sites, provided in property tax bills, customer billing statements, and be available from cities, counties and libraries. Districts should be required to publicly notice all meetings in local newspapers, invite coverage by local cable television and conduct annual mailings to district residents.

- ***Require special districts to submit information to other local governments.*** Independent special districts also should annually and publicly present financial information to county boards of supervisors and city councils, which represent the broader community of interests. Districts also should submit budgets and financial audits to their Local Agency Formation Commission, which could then determine which districts warrant closer scrutiny.
- ***Encourage special district elections to be held as part of even year general elections.*** To increase voter participation in special district elections, counties should be encouraged to consolidate special district elections in even-year general elections.

Finding 2: Local Agency Formation Commissions, by not aggressively scrutinizing the organization of special districts, have failed to promote the efficient and effective evolution of independent special districts.

The State created LAFCOs in counties and charged them with fostering the rational and orderly evolution of local government. It subsequently gave them the authority to initiate special district consolidations. But LAFCOs often lack the technical skills or political will to make change. LAFCO officials report that the commissions are often ineffective because they lack independence, clear direction from the State and funds to conduct studies. Another longstanding concern is that compensation paid to board members discourages them from giving up their seats in the name of efficiency. The Commission found evidence that this could be the case in some districts.

These problems are exemplified by California's 24 health care districts that no longer operate hospitals. Having sold, leased or closed their hospitals, the districts endure. Nearly half of them pay meeting stipends or benefits to elected board members. But LAFCOs consistently fail to examine these districts to determine whether they should be eliminated.



Where consolidations have occurred, particularly in urbanizing communities, services have been improved and costs reduced. Water and sanitary districts in Orange County reduced administrative

overhead by eliminating two general managers, cut the number of board members from 17 to five, improved customer service and integrated infrastructure as a result of consolidation. Over time, they expect to save \$1 million annually.

Following a decades-long trend toward a regional fire service, districts in Sacramento County merged to create an agency that will cover nearly 400 square miles and serve 600,000 people. They will save money through lower overhead costs, a reduction in the number of management positions, economies of scale in purchasing equipment and supplies, and a reduction in the number of elected officials.

The Little Hoover Commission believes that decisions about the form and function of independent special districts in California are best made locally. But it finds that LAFCOs often do not have the capacity or will to make informed and economically sound decisions, particularly regarding independent special districts.

Recommendation 2: The State should provide LAFCOs with the direction and resources necessary to make them a catalyst for the effective and efficient evolution of independent special districts. Specifically, the Governor and Legislature should:

- ❑ **Require periodic and specific reviews of independent special districts.** The State should require LAFCOs in urbanizing counties, in cooperation with special districts and other local governments, to periodically review services provided by special districts. The reviews should identify areas of duplication and overlap and assess whether services are being provided in the most efficient and cost-effective manner. Where duplication, overlap and inefficiency are identified, LAFCOs should be required to initiate a study. Specific triggers could be established, such as when the fundamental mission of a district changes or reserves exceed defined limits.
- ❑ **Enhance the independence of LAFCOs.** The State should encourage LAFCOs in urban counties to appoint their own executive officer and legal counsel, thereby establishing employment relationships free of the real and perceived conflicts that occur when county employees hold those positions.
- ❑ **Require shared funding of LAFCOs.** To increase the resources available to LAFCOs, enhance their independence and increase their effectiveness, the State should require counties, cities and special districts to jointly fund LAFCOs. Special districts should contribute whether or not they have opted to sit on a LAFCO.
- ❑ **Identify funds for studies.** The State should require special districts that are the subject of a required LAFCO study to fund the study. For financial hardship cases, the State should provide grants or loans, which could be repaid from savings accrued as a result of reorganizations.

Finding 3: Policy-makers and community leaders lack the analytical tools necessary to assess the benefits of consolidation, impeding their ability to advocate effectively for change and overcome the tenacity of the status quo.

Reliable information is needed to aggressively and assertively fuel the evolution and optimize the use of special districts. These tools are especially important as communities strive to efficiently provide housing and transportation in growing urban areas, concepts known as “smart growth.” Research is needed that will help policy-makers and community leaders know when consolidations will achieve improved efficiency and service and identify strategies for facilitating those consolidations. Policy-makers also need guidelines, best practices and

access to a cadre of experts who can provide technical assistance and training. Absent these resources, even if LAFCOs are independent and have the political will, resistance from board members and the momentum of the status quo will prevent the evolution of independent special districts.

The State can play an important role in building the competence necessary for effective and informed local decision-making. The California Policy Research Center (formerly the California Policy Seminar) was created at the University of California to inform California's policy-makers about the most pressing issues of the day. The resources of this center, or other private and public institutions like it, could fill the information void that in some communities works to prevent structural reforms.

Recommendation 3: To equip policy-makers and the public with the tools necessary to assess and guide the organization of independent special districts, the Governor and Legislature should establish a program at the California Policy Research Center, or similar institute, to do the following:

- ❑ ***Develop guidelines and protocols for special district consolidations.*** The consulting research center should conduct research to identify conditions when consolidation or reorganization of special districts will result in cost-savings, improved service and other benefits.
- ❑ ***Study the long-term outcomes of consolidations and reorganizations.*** The consulting research center should review and quantify the long-term outcomes of special district consolidations and reorganizations.
- ❑ ***Establish a cadre of trainers.*** The consulting research center should establish a cadre of experts to provide training and technical assistance to LAFCOs, enabling them to perform periodic reviews and analyze and facilitate special district consolidations. They could also be called to advise in instances where conflicts arise between special districts and their customers.
- ❑ ***Develop performance measures.*** The consulting research center, in cooperation with the California Association of Local Agency Formation Commissions, California Special Districts Association and Special Districts Institute, should develop and encourage special districts to establish and report performance measures as a means of building public understanding and support.

Finding 4: Hundreds of independent special districts have banked multi-million dollar reserves that are not well publicized and often not considered in regional or statewide infrastructure planning.

In 1996-97, the most recent year for which data is available from the State Controller, independent special districts reported \$19.4 billion in retained earnings and fund balances. Enterprise districts, which charge fees for their services, reported \$18.2 billion in retained earnings. Non-enterprise districts, which rely on property taxes, reported \$1.2 billion in fund balances. More than 600 districts reported reserves of \$1 million or more. More than 1,300 districts have reserves in excess of their gross annual revenue.² From a state perspective little is known about these funds, including how they are invested or the purposes for which they are earmarked. State law specifies that local government agencies are to make relatively conservative investments. But there is virtually no oversight by the State or other local governments of the investment policies and practices of special districts. And there are no standards guiding the size and use of reserve funds. These issues are of concern, as evidenced by pending legislation that would require all local governments to submit their investment portfolios to the California Debt Advisory Commission in the State Treasurer's Office.

The size of special district reserves raises a number of important policy issues.

- ✓ Special district reserves represent significant public resources. Many districts have good rationales for maintaining reserves at certain levels, including providing a cushion during lean years and permitting investment in infrastructure. But the size of the reserves and how they are invested are often not understood by community leaders and district customers.
- ✓ The State and local communities are grappling with the need to fund infrastructure that will contribute to California's continued prosperity. But the resources of special districts frequently are not considered in plans to meet these needs. The resources and capacities of special districts could play a larger role in planning and financing regional and statewide infrastructure.
- ✓ There are no guidelines for accumulating or using reserves and no oversight of the investment practices of special districts. Reserve and investment policies and practices could be improved through the establishment of guidelines and enhanced scrutiny.

A number of steps should be taken to help communities understand and make the best use of special districts and their assets.

Recommendation 4: The Governor and Legislature should enact policies that will ensure prudent management of special district reserve funds and incorporate these resources into regional and statewide infrastructure planning. Specifically, the State should require:

- ❑ **Districts to publicize their reserves.** Districts should be required to clearly identify and publicly report, in terms understandable to the public, the size and purpose of reserves and how they are invested. The information should be included in budgets and audited financial statements, highlighted on district Web sites, reported to boards of supervisors and city councils and sent to customers, as described in Recommendation 1. Special districts also should be required to adopt and publicize policies for the accumulation and use of reserves by the district.
- ❑ **Policy-makers to integrate enterprise district reserve information into infrastructure planning.** The services and assets of enterprise districts should be included in regional and statewide infrastructure planning. To this end, special districts should be required to coordinate their activities with other districts and general-purpose governments and to participate in the development of county general plans.
- ❑ **Guidelines for prudent reserves.** The Governor and Legislature should appoint a panel including experts in finance, management and government, and community representatives, to recommend guidelines for establishing and maintaining prudent reserves by special districts. The panel also should review the investment policies and practices of districts and determine if additional oversight is warranted.

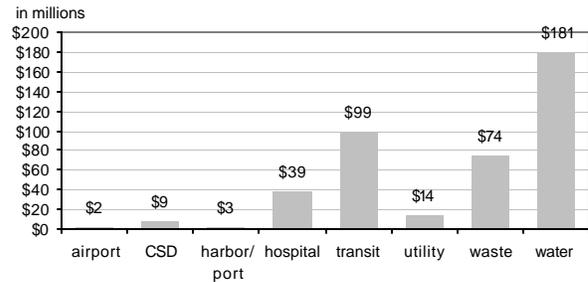
Finding 5: Property tax allocations to some enterprise districts create inequities among districts and distort the true costs of services. A significant portion of the property tax allocated to all enterprise districts subsidizes districts with the highest reserves.

Those enterprise districts that levied property taxes prior to the 1978 passage of Proposition 13 continue to receive property tax allocations. Those districts also charge customers fees for water, sewer and other services they provide. In 1996-97, independent enterprise districts received \$421 million in property tax allocations. Water districts, which generate the highest annual revenues and maintain the largest reserves of all special districts, received 38 percent of that amount, a total of \$161 million.

The allocation formulas may have made sense when they were implemented more than two decades ago. But over time the logic has faded. Significant policy questions are raised by the continuing practice of allocating property taxes to enterprise districts.

✓ Property taxes subsidize the cost of providing services in some districts. This practice allows some districts to rely on these revenues to keep rates low or provide a higher quality of services. Other districts offering similar services must rely solely on fees to cover those costs. The property tax subsidy also can exaggerate inequities among classes of ratepayers within a district.

Property Tax Allocated to Independent Enterprise Districts



Source: State Controller, 1996-97 Property Tax Data, on file.

✓ Some districts that continue to receive property tax revenues are among those that have the highest reserves. Meanwhile, non-enterprise districts such as parks and recreation and library districts have seen their revenues dwindle and their ability to provide services diminished.

✓ Taxpayers do not understand how their property taxes are allocated among the special districts serving them. And they do not know how these allocations affect their rates or quality of services, preventing them from providing feedback to district officials.

These issues should be explored in any discussion of property tax allocations to enterprise districts. Beyond the dollars involved, policy-makers and the public must understand the consequences of the current policy for taxpayers generally and for some customers specifically. They also need to understand consequences for districts that cannot charge fees and have seen their property tax revenues diminished.

Recommendation 5: Policy-makers should scrutinize the appropriateness of maintaining property tax allocations to enterprise districts. Among the alternatives:

❑ **Annually review the level of property tax support.** The Controller could annually report the property tax revenue distributed among enterprise districts with the largest reserves. With the assistance of the Legislative Analyst, and as part of the budget process, the Legislature could decide whether to continue or modify this allocation of property taxes.

- ❑ **Examine all allocations to enterprise districts.** The Legislature could appoint a task force to examine how individual enterprise districts use property tax revenues. The task force could identify districts that should continue to receive the revenues, those that should receive smaller allocations, and those that should no longer receive property tax revenue.
- ❑ **Require a state audit of some districts.** The Legislature could require the State Auditor to examine enterprise districts that receive property taxes and also have the highest reserves. The Legislature could then take specific action to reduce or eliminate the allocations to those districts without a strong rationale for tax funding.
- ❑ **Allow counties to reclaim and reallocate property tax revenues.** The Legislature could provide a mechanism for counties, following a public review process, to reclaim property tax revenues from enterprise districts and reallocate those funds to meet contemporary community needs and priorities.
- ❑ **Enhance public understanding of property tax allocations.** Property tax bills should identify for taxpayers the independent special districts that provide services to them, along with the tax allocation, reserves and other financial information about those districts.

Notes

- i. The retained earnings presented in this report were provided by the State Controller's office. Prior to the release of the report, the Controller's office asserted that its definition of retained earnings did not include fixed assets or infrastructure. As part of its research, the Commission contacted several districts, which confirmed the accuracy of the Controller's information. Subsequent to the report's release, the Commission has become aware that some districts include some of their fixed assets in the values they report to the Controller as retained earnings. The Controller's office now believes that to accurately separate fixed assets from other retained earnings would require a detailed case-by-case analysis.
1. Personal communication.
2. State Controller, 1996-97 data on special district retained earnings and fund balances, on file. The term reserves refers to retained earnings, fund balances, or a combination.